No. 10088

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

CONSOLIDATED ROYALTIES, INC., a corporation, and C. B. CALLAHAN,

Appellants,

vs.

HARRY ASHTON, Trustee of the Estate of Deep Hole Drilling Corporation, Bankrupt, *et al.*,

Appellees.

REPLY OF APPELLANTS TO AMICUS CURIAE BRIEF OF JOSEPH J. RIFKIND IN SUPPORT OF APPELLEE.

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The *amicus curiae* brief of Joseph J. Rifkind in support of Appellee, under the Statement of Case, states that the bankrupt incurred divers obligations in the drilling of Well No. 2 located upon the same leasehold premises as Well No. 1. As a matter of fact, Well No. 2 did not involve the same leasehold premises and was drilled on property in which Appellants had no interest whatsoever. Great emphasis is placed by Mr. Rifkind upon the fact that under California law, before an interest in a mining

title or lease may be conveyed, a permit must be obtained therefor, which conveyances, for the purposes of the Corporate Securities Act, and that Act alone, are denominated "securities."

Under Point I of his brief, Mr. Rifkind argues that the *Laugharn* case does not overrule the *Lathrap* case as to an interest created by an operating lessee, because the Court relied on *Callahan v. Martin,* 3 Cal. (2d) 110, which involved only the interest of a landowner lessor and not the interest of an operating lessee. He quotes from *Schiffman v. Richfield Oil Co.,* 8 Cal. (2d) 211, to the effect that the Supreme Court was unwilling at that time to apply the landowner-lessor rule to an operating lessee's interest and concludes by quoting a portion of *Dougherty v. California Kettleman Oil Royalties, Inc.,* 9 Cal. (2d) 58, which held that a royalty conveyed under a lease for a definite term of years was personal property. Mr. Rifkind fails to point out that the lease in our matter was for a term of years and so long thereafter as oil should be produced, which type of lease has long been held to be real property in this state. He also has failed to point out that the Supreme Court of California has now extended the landlord-lessor real property principal to the interest created by an operating lessee who conveys an overriding royalty. The case of *La Laguna Ranch Co. v. Dodge,* 18 Cal. (2d) 132, already cited in Appellants' briefs expressly states on page 140 that:

> "Defendants' overriding royalties were, therefore, interests in real property."

The portion of the *Laugharn* case cited by Mr. Rifkind on page 4 of his brief is therefore most appropriate. It is as follows:

> "Therefore, we must and do overrule the prior decisions of this court in so far as they are inconsistent with the settled law of California as adjudged by the California courts. On this basis we hold the assignments in the instant case to be conveyances of an interest in real property and not to be executory contracts."

Under Point II, Mr. Rifkind makes the broad assertion that the purchaser of a fractional interest in production from an oil well is an investor whose rights are subordinate to the rights of creditors. In an attempt to substantiate this broad assertion it is apparently his contention that any person who purchases property from a vendor with the expectation of making a profit is an "investor" who should be subject to the rights of creditors of such vendor. In an attempt to justify this contention, Mr. Rifkind refers to the Corporate Securities Act of the State of California, which requires a permit to be secured by an owner before executing and delivering a certificate of interest in an oil, gas or mining title or lease. He states that because royalty assignments and grant deeds conveying a fractional interest in oil properties have been construed to be within the purview of the Act. this constitutes the holder of an overriding royalty assignment the owner of a security similar to a stockholder in a corporation. Such is not the fact. Cases cited by him have to do

with violations of the penal statute which was enacted to prevent loss to purchasers through fraud of a vendor and in the case of corporations to see that stock be not issued without consideration therefor. (*People v. Kudder,* 98 Cal. App. 206.) In other words, the purpose of this Act is to see that a purchaser obtains what he pays for and to see that the corporation selling the security, in the case of corporations, receive consideration required by the permit before the property is conveyed, in order that creditors of the corporation may be protected.

There is no provision in the Corporate Securities Act which states that the purchaser of an overriding royalty interest becomes a preferred stockholder or limited partner or an investor in the business of the vendor. The fact that the Corporate Securities Act covers royalty interests has no bearing whatsoever upon the issues of this case and the case of *People v. Kudder, supra,* indicates that when the purchaser has received what he pays for and has actually paid to the vendor the consideration required, the creditors are protected. Certainly, those creditors, who, with knowledge of the recorded conveyance of this oil to Appellants, continued to extend credit to the bankrupt, should not be entitled to claim that Appellants must, in addition to the consideration paid for their fractional interest of oil, deliver to such creditors the oil itself. There is nothing in the Corporate Securities Act which would sanction such a contention and such contention is contrary to equitable principles.

Mr. Rifkind ignores a further material difference between the conveyance in our case and that involved in the cases cited by him. The interest of appellants in this matter was an overriding royalty interest and conveyed

12% of the oil to be produced from Well No. 1 and not merely the right to participate in profits after deducting expense as in the case of *People v. McCalla,* 63 Cal. App. 783, and *In re Hawkeye Oil Company,* 19 Fed. (2d) 151. This constitutes the fundamental distinction. The *Hawkeye Oil Company* case which Mr. Rifkind states involves a similar type of investment certificate, in fact involves a participation operation certificate. There was no conveyance in that contract of the gasoline to be sold, but only the right to participate in the daily receipts on gasoline and all other merchandise sold by the issuer of the certificate. The reasoning of this case cannot be applied to a case where title to the 12% of the oil was conveyed to Appellants. The cases of *People v. McCalla,* 63 Cal. App. 783, and *Domestic & Foreign Petr. Co. v. Long,* 4 Cal. (2d) 547, both involve the Corporate Securities Act.

Mr. Rifkind under Point II again refers to *Schiffman v. Richfield Oil Co.,* 8 Cal. (2d) 211, and to the abstract question there raised, but intentionally not answered, as to whether percentage assignees might be liable for the production enterprise if they had the right to participate in the management of the production enterprise. The case of *La Laguna Ranch Co. v. Dodge, supra,* as well as *Spier v. Lang,* 4 Cal. (2d) 711, and other cases, clearly show that Appellants had no right to participate in the management of the company. Mr. Rifkind quotes from the *La Laguna Ranch Co. v. Dodge* case to the effect that the lessee had the right to quitclaim under the lease and that such terminated the interest of the overriding royalty holders and states that this case is authority for subordinating the rights of the royalty holders to the rights of the operating lessee. It is significant, however, that this

right to quitclaim was expressly reserved in the lease and the royalty holders acquired their assignments with knowledge of this provision. The court simply enforced the terms of the contract. There is no agreement or contract whatsoever in our case to the effect that Appellants' right, title and interest in the oil may be subordinated to the payment of the vendor's indebtednesses.

Conclusion.

It is respectfully urged that under California law Appellants acquired 12% of the oil produced from the well by a conveyance which was recorded long prior to insolvency and after the well was on production for many weeks. If the creditors saw fit to extend additional credit to the bankrupt with knowledge of this conveyance in hope and expectation of receiving additional profits from the sale of materials and labor on other enterprises of the bankrupt, certainly they should not be entitled to reach back over the months and, because their operations proved unprofitable, seek to obtain Appellants' property in payment of their claims. This reasoning is both logical and equitable and Appellants believe and urge that the authorities cited by them sustain their position.

Respectfully submitted,

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